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Office-Supreme Court, U.S.
FILED
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JOHN F. DAVIS, CLERK

In the

Supreme Court of the United States

OCTOBER TERM 1964

No. 899

MURPHY OIL CORPORATION,

Petitioner,

v.

UNITED STATES OF AMERICA,

Respondent.

MOTION OF RICHARD A. FRELING FOR LEAVE TO FILE BRIEF *AMICUS CURIAE* AND BRIEF *AMICUS CURIAE* IN SUPPORT OF PETITION FOR A WRIT OF CERTIORARI TO THE COURT OF APPEALS FOR THE EIGHTH CIRCUIT

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MOTION OF RICHARD A. FRELING FOR LEAVE TO FILE BRIEF AS *AMICUS CURIAE* IN SUPPORT OF PETITION FOR A WRIT OF CERTIORARI TO THE COURT OF APPEALS FOR THE EIGHTH CIRCUIT

I, Richard A. Freling, respectfully move this Court for leave to file the accompanying brief in support of the Petition for a Writ of Certiorari in this case as *amicus curiae*. The consent of the attorney for the Petitioner herein has been obtained, but the attorney for the Respondent herein has refused to consent to my filing a brief as *amicus curiae*.

I am an attorney in Dallas, Texas, engaged primarily in the practice of law relating to matters of Federal taxation. I represent various clients engaged in the oil and gas business, but I have not communicated with any of such clients regarding the pendency of the Petition for a Writ of Certiorari in this case nor my intention to file this motion or the accompanying brief. I do not represent any client having, to

my knowledge, any case pending before the Internal Revenue Service or any court involving the issue of law involved herein. I am undertaking to file the accompanying brief as an active practitioner interested in the development of this specific issue of law, and, because I have authored several articles on the subject, as an academician.

In particular, the court below in the instant case[1] cited a statement from my article, *Bonus Payments Through the Looking Glass*,[2] in support of its decision against Petitioner that *Burton-Sutton Oil Co. v. Comm'r.*, 328 U.S. 25 (1946) did not control the issue of law before the court. The quotation was taken out of context, and was employed by the Court of Appeals in reaching a decision completely contrary to the conclusions of my article.

The decisions of the Court of Appeals and the District Court continue to interpret the law erroneously, contrary to other decisions of this Court and to fundamental concepts of taxation. I therefore respectfully urge the Court to grant this motion, so that I may voice my position on this important point of law.

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[1] See Petition for a Writ of Certiorari filed herein, Appendix B-3.
[2] Prentice-Hall, Oil and Gas Taxes § 2027 (1962).

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Respondent's regulations treat a bonus paid for an oil and gas lease inconsistently to the lessor and the lessee, thereby subjecting the lessee to an increased tax burden because he has expended his capital in the pursuit of profit. The lessee should be entitled to exclude a bonus ratably over the life of the lease for all purposes of Federal income taxation, or should not be required to exclude a bonus for any purpose. 2

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BRIEF OF RICHARD A. FRELING AS *AMICUS CURIAE* IN SUPPORT OF PETITION FOR A WRIT OF CERTIORARI TO THE COURT OF APPEALS FOR THE EIGHTH CIRCUIT

By leave of this Court, I, Richard A. Freling, file this brief as *amicus curiae.*

INTEREST OF THE *AMICUS CURIAE*

My interest as *amicus curiae* is set forth generally in the motion which this brief accompanies. To reiterate, I have no direct interest in this case or any related or analogous case, and this brief is filed as an expression of my discontent, as an active practitioner and author, with the illogical

and totally unfair interpretation of the law espoused by Respondent and sustained by the courts below.

ARGUMENT

The assignment of an interest in an oil or gas property or lease, subject to the retention by the assignor of a continuing royalty, constitutes a lease or sublease for Federal income tax purposes under the decisions of this Court.[1] Any cash consideration paid to the "lessor" or "sublessor" represents a bonus which, in the hands of the recipient, is treated as advance royalty income, subject to an appropriate allowance for depletion. Although the characterization of a bonus as an advance royalty may, as an initial proposition, be open to criticism,[2] my concern is not with that characterization but with the persistent failure of Respondent to apply it consistently to both the recipient-lessor and the payor-lessee.

Respondent's regulations[3] provide that the lessee must capitalize the bonus as his basis for the leasehold estate. Nevertheless, the lessee must each year exclude from his

[1] *Burnet v. Harmel*, 287 U.S. 103 (1932); *Palmer v. Bender*, 287 U.S. 551 (1933). See also *Hogan v. Commissioner*, 141 F. 2d 92 (5th Cir. 1944); G.C.M. 22730, 1941-1 Cum. Bull. 214.

[2] Despite the fact that the lessor retains a continuing economic interest in the minerals in place, the cash consideration for the assignment of a defeasible fee or other estate in the remainder of the minerals in place might well have been categorized as capital gains to the assignor. In that event, the issue now involved in the Petition for a Writ of Certiorari could not exist. In other words, the lessee would not be compelled to exclude the bonus from his gross income in computing percentage depletion or for any other purpose.

[3] Reg. § 1.612-3(a)(3), IRC of 1954.

gross income for purposes of computing percentage depletion an amount equal to a ratable portion of the bonus,[4] the reason allegedly being that the lessor has already claimed depletion with respect to this income (*i.e.*, the advance royalties with which the lessor was charged). However, the regulations turn right around and deny the lessee the right to exclude the amount of the bonus for purposes of calculating his taxable income on the ground that the bonus is part of his leasehold basis which must be recovered only through deductions for depletion.

The regulations therefore penalize the lessee — require him to pay additional taxes — because (not in spite of, but because) he has made an investment (presumably with tax paid dollars) in pursuit of profit. The very statement of the result is so incredible, that one may reasonably wonder about the validity of the statement. Yet, the result under the regulations is demonstrable and irrefutable.

For example, assume that *A* and *B* are both independent oil operators, and that the income of both is taxed in the 50 percent bracket. *A* negotiates a lease on Blackacre, for which he pays a cash bonus of $100,000, and the lessor reserves a one-eighth royalty. *B* obtains a lease on adjoining Whiteacre without paying a bonus, and his lessor also reserves a one-eighth royalty. We may assume for purposes of our illustration that production from each lease over its life is $800,000; the expenses attributable to each lease are

[4] Reg. § 1.613-2(c)(5)(ii), IRC of 1954; Reg. 118, Sec. 39.23(m)-1(e)(5).

$100,000; percentage depletion exceeds cost depletion to *A* in each year; and the 50 percent of taxable income limitation on percentage depletion is never applicable. The taxable income of *A* and *B* over the life of the properties is as follows:

	A	B
Total Income from Production	$800,000	$800,000
Less: Royalty to Lessor	100,000	100,000
Lessee's ~~Lessor's~~ Gross Income from Production	700,000	700,000
Percentage Depletion ($700,000 [less bonus, if any] x 27½%)	165,000	192,500
Expenses	100,000	100,000
Taxable Income	435,000	407,500
Tax @ 50%	217,500	203,750
	203,750	
Difference in Tax	$ 13,750	

Of course, the facts set forth in the example are not likely to occur in such close tandem, so that the effect of the regulations becomes masked. However, it is clear that, as determined under the regulations, *A's* taxable income exceeds *B's* taxable income by the amount of depletion on the $100,000 bonus which *A* was required to exclude for purposes of that computation. It cannot be gainsaid, therefore, that *A's* taxes (and, indeed, the taxes of every lessee who pays a bonus) are greater than if he had not paid a bonus, *i.e.*, he is penalized taxwise for having invested his capital in the production of income. Viewed in this light, a reasonable argument

might be advanced that the regulations are unconstitutional as imposing a tax on capital, not the income therefrom.

In any event, it seems to me that the result produced by the regulations cannot be tolerated within our fundamental concepts of taxation. The regulations are wrong, and the decisions which uphold the regulations are wrong. With all due respect, the early courts which were confronted with this problem simply bogged down in the weight of their own logic,[5] and only Judge Learned Hand, dissenting in the

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[5] *Canadian River Gas Co. v. Higgins*, 151 F. 2d 954 (2d Cir. 1945); *Sunray Oil Co. v. Commissioner*, 147 F. 2d 962 (10th Cir. 1945); *Quintana Petroleum Co. v. Commissioner*, 143 F. 2d 588 (5th Cir. 1944). These courts began with the premise that the bonus represented the cost of the leasehold to the lessee and must therefore be capitalized as leasehold basis. Once this conclusion was accepted, the courts were trapped in the middle of the arguments which, on the one hand, preclude recovery of leasehold basis except through deductions for depletion, and, on the other hand, require the lessee to exclude from gross income the amount of income on which the lessor has claimed depletion.

The fallacy lies in the basic premise. This Court said in *Burton-Sutton Oil Co. v. Commissioner*, 328 U.S. 25 (1946) that, with respect to payments between lessors and lessees of oil and gas properties, "If they are capital investments to one, they are capital sales to the other. If they are rents or royalties paid out to one, they are rents or royalties received by the other." The Court of Appeals rightly quoted from my article *Bonus Payments Through the Looking Glass*, Prentice-Hall, Oil and Gas Taxes § 2027 (1962) to the effect that a capital investment to the payor is not necessarily a capital sale to the payee. However, the Court of Appeals stopped there, and thus missed the point entirely. This Court requires only that a bonus have a reciprocal identity in the hands of both the lessor and the lessee. It is an advance royalty received by the lessor and thus must be an advance royalty paid by the lessee. If the payment results in a benefit extending over several years, then the bonus should be capitalized as an accounting matter, but it should not be capitalized as or merged with basis for the leasehold estate. It should be capitalized as what it is: prepaid or advance royalties.

Canadian River Gas case,[6] correctly analyzed the law and pointed the way towards solution. More recently, the Tax Court[7] appears to have abdicated its responsibility in favor of the Congress, and the courts below in the instant case seem to have been swayed by the length of time during which the error in the regulations has gone uncorrected.

On the other side of the street stand the decisions in *Lambert v. Jefferson Lake Sulphur Company*,[8] which are in conflict with those of the courts below, and the decisions of this

[6] *Canadian River Gas Co. v. Higgins, supra* note 5 at 957, wherein it is stated:

> "The reason for this, as I gather, is that such a 'bonus' is payment in advance for units of gas, in which, although the lessee has the right to withdraw them in the future, the lease gives him no immediate interest. Conversely, the lessor does not part with any interest in the gas until the lessee withdraws it. These decisions thus put a 'bonus' on the same footing as current royalties, in spite of the fact that it is not apportioned to future withdrawals, and is not recoverable, if there are no withdrawals; and it is because it is upon that footing that it is income. The important thing to observe is that this consequence is a deduction from the rights which the lease creates.
>
> "The plaintiff merely asks that the lease shall be construed in the same way, when the lessee is taxed. It says that if a 'bonus' is 'advance royalties,' and a payment for units to be later withdrawn, which remain the lessor's while they are in situ, it must be 'advance royalties,' when the opposite party, the lessee, is taxed: that the rights created cannot vary as one looks through different ends of the same document. My brothers find it a sufficient answer to say that the same payment may be at once income to the payee, and a capital expenditure to the payor. That is true: for example, when a customer buys goods from a merchant, he may be making a capital expenditure, yet the merchant will receive income. Nevertheless, the legal effect of the transaction does not shift; the same contract is not construed to create one kind of right when the customer is to be taxed, and another when the merchant is. Yet that is what we must do here, if we are to escape the force of the decisions I have mentioned * * *"

[7] Shamrock Oil and Gas Corp., 35 T.C. 979 (1961).

[8] 236 F. 2d 542 (5th Cir. 1956), *aff'ing*, 133 Supp. 197 (D.C. La. 1955).

Court in *Burton-Sutton Oil Co. v. Commissioner*,[9] *Andersen v. Helvering*,[10] and *Burnet v. Harmel*,[11] the principles of which also require reversal of the instant case.

The real issue, in my opinion, is not whether the present regulations should be modified, but rather the correct basis on which such modification should be made. The alternatives are clear: (1) a lessee should be required and entitled to exclude the amount of a bonus paid for an oil or gas lease from his gross income for all purposes of Federal income taxation, or (2) a lessee should not be required to exclude the amount of a bonus paid for an oil or gas lease for any purpose.

As a corollary to the first alternative, the bonus exhaustion formula could be retained, but the bonus would be capitalized as something (*e.g.*, prepaid royalties) other than as basis for the lessee's leasehold estate. This would be consistent with the treatment of advance royalties to the lessor, and would not disturb other traditional oil and gas tax concepts. The bonus exhaustion formula would then dictate the amount which would be excluded from the lessee's gross income for all purposes. As a corollary to the second alternative, the total gross income subject to depletion by the owners of all the economic interests in the lease would be measured by the actual gross income from production plus the amount of the bonus. In other words, the income on which the lessor claims depletion would not be the same as, but would be in

[9] 328 U.S. 25 (1946).

[10] 310 U.S. 404 (1940).

[11] 287 U.S. 103 (1932).

addition to, the income on which the lessee claims depletion. Hence, there would be neither reason nor justification for requiring the lessee to exclude the amount of the bonus for purposes of computing his percentage depletion.

CONCLUSION

As *amicus curiae*, I urge the Court to grant the Petition for a Writ of Certiorari, and upon hearing of the case to reverse the decisions below and render judgment in favor of the Petitioners.

Respectfully submitted,

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CERTIFICATE OF SERVICE

I, Richard A. Freling, *Amicus Curiae*, and a member of the Bar of the Supreme Court of the United States, hereby certify that on the .... day of March, 1965, I served copies of the foregoing Motion and Brief upon the Solicitor General, Department of Justice, Washington 25, D. C., upon counsel of record who represented the United States of America, Respondent herein, in the court whose judgment is sought to be reviewed, and upon counsel of record for Petitioner herein, all by depositing same in a United States Post Office, with first class (and airmail, where necessary) postage prepaid, addressed to such counsel at their respective post office addresses, and otherwise in accordance with the applicable rules of this Court.

.....

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